Testimony of Dr. Thomas S. Neubig
Ernst & Young LLP before the
House Committee on Education and the Workforce
"Fiscal Responsibility and Federal Consolidation Loans:
Examining Cost Implications for Taxpayers, Students, and Borrowers"

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Mr. Chairman and Members of the Committee:

I am the National Director of Ernst & Young LLP's Quantitative Economics and Statistics practice. I was previously the Director and Chief Economist of the U.S. Treasury Department's Office of Tax Analysis.

I appreciate the invitation to testify before the Committee to discuss the results of two studies on the costs and benefits of the Federal Family Education Loan (FFEL) consolidation student loan program. The two reports, "The Net Incremental Cash Flow and Budget Effects of the FFEL Consolidation Loan Program, FY2005-FY2010" and "The Effect on Student Borrowing Costs if Consolidation Loans Were Variable Rate Loans Rather Than Fixed Rate Loans," are also submitted for the record. Both reports were prepared at the request of Collegiate Funding Services LLC. My testimony summarizes the key findings from the reports, with estimates updated for the most recent loan volume and interest rate projections.

Two Key Considerations

Two key considerations for policymakers considering the cost implications of consolidation loans during the coming Higher Education Act reauthorization are:

1. **Consolidation student loans are not all alike from a cost perspective. The cost of future consolidation loans will be much less than the estimated cost of the current 3.5% loans.**

Depending on the interest rate environment, a year's issuance of consolidation loans could bring in significant fee revenue to the U.S. government or could require significant expenditures. Three groups of consolidation loans should be distinguished:

- Loans made before FY03 have already generated $1.7 billion of consolidation loan fees from lenders to date with only $0.3 billion of government payments to lenders. The estimated net cost of the consolidation loan program for loans originated in FY1995-2002 is a positive $3.7 billion over the life of the loans.

- Loans made between FY03 and FY06 are expected to have significant future subsidy costs if the predicted sharp increase in interest rates occurs. Consolidation loans made at

historically low interest rates during this four-year period are estimated to cost $6.1 billion over the life of the loans in net present value.

- Loans made after FY06, when the interest rate forecast is relatively stable, are estimated to have fees that will exceed expenditures. The estimated net cost of loans made in FY2007-2010 is a positive $2.3 billion.

The large estimated cost of current consolidation loans is due to current historically low interest rates combined with projected higher future interest rates. These loans will provide significant interest savings to student borrowers if the projected interest rate increases occur. The costs and benefits of these loans have already been committed. This is why the August 2003 report focused primarily on future loans.

2. The real cost of the consolidation loan program is its additional cost over and above the cost of the underlying Stafford/Plus loans (i.e., its "incremental" net cost) less lender-paid consolidation fees.

Measuring the real cost of the consolidation loan program is not easy, and its further complicated by the many different types of estimates that are possible. I believe the appropriate cost for policymakers to consider will include:

Fee offset. The cost of the consolidation loan program from defaults and special allowance payments is partially offset by the 0.5% origination fee and the annual 1.05% consolidation loan holder fee. These lender-paid fees are generated from consolidation loans and reduce the net cost of those loans.

Incremental cost. If fewer consolidation loans were made, there would be more interest subsidy paid on the Stafford/Plus loan program. The cost of consolidation loans is the cost over and above the interest subsidy on the underlying Stafford/Plus loans, less the lender-paid consolidation fees.

Discounted present value of future cash flows. The Federal Credit Reform Act (FCRA) of 1990 requires the budget effect to be calculated as the net present value of the future cash flows over the life of the loans issued in each year. Simply adding future dollars without discounting is inconsistent with the FCRA and overstates the costs of the consolidation program.

Future interest rate projections. Interest rate forecasts, like interest rates, change over time as the economy changes. For budgeting purposes, the Congressional Budget Office and Office of Management and Budget forecast interest rates over the next 5-10 years. These forecasts underlie not only student loan costs, but also the government's interest expense, the macroeconomic forecast of GDP, employment and tax revenues. Extreme scenarios of interest rate increases are inconsistent with every other budget forecast.

Estimates that do not take these issues into account will overstate the cost of the FFEL consolidation loan program.

The Budget Cost of Consolidation Loans

The August 2003 report on "The Net Incremental Cash Flow and Budget Effects of the FFEL Consolidation Loan Program, FY2005-FY2010" showed that on a cash flow basis the program has been a net plus to the federal government since 1995. I have updated the numbers for the most recent Department of Education budget numbers and loan volume forecasts, plus the CBO's most recent interest rate projections.

Consolidation loan fees have totaled $2.6 billion through FY03 while gross special allowance payments have been only $0.4 billion. Based on the most recent Department of Education FY05 Budget numbers, the FFEL consolidation loan program will bring in an additional $2.2 billion of lender-paid fees, with only $0.5 billion of expenses in FY04 and FY05. These cash flow numbers represent the actual fiscal experience to date of the program, but they are not the full cost, which requires projecting future interest rates and the future cash flow for the entire life of the loans.

Historical Cash Flow of the FFEL Loan Consolidation Program

($ millions)

	Income			**Cost**	
Fiscal Year	**Lender Origination Fee**	**Lender Holder Fee**	**Total Fees**	**Gross Special Allowance Payment**	**Net Cash Flow**
1995	23	22	45	0	45
1996	22	66	88	0	88
1997	12	130	142	0	142
1998	16	131	147	53	94
1999	25	196	221	92	129
2000	27	210	237	6	231
2001	28	287	315	129	186
2002	91	383	474	34	440
2003	176	743	919	61	858
Total FY 95-03	**420**	**2,168**	**2,588**	**375**	**2,213**
Estimated					
2004	128	925	1,053	68	985
2005	110	1,031	1,141	476	665
Total FY 95-05	**658**	**4,124**	**4,782**	**919**	**3,863**

Source: Department of Education Federal Budget Appendices, FY1996-2005

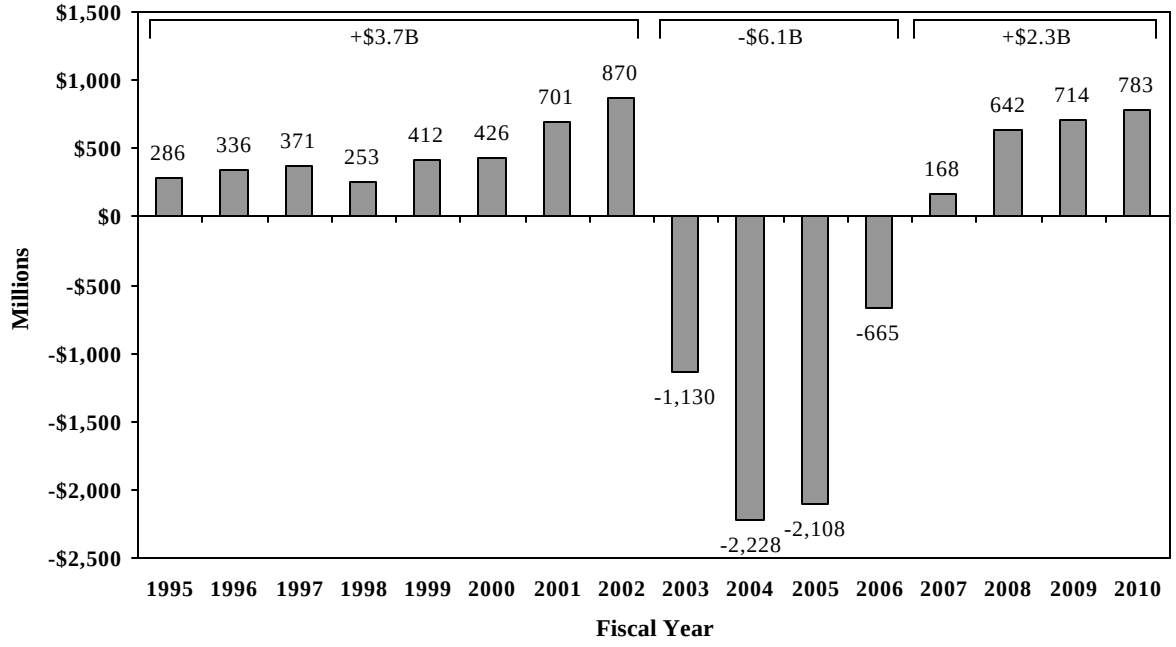
The figure below shows the estimated cost of the three groups of FFEL consolidation loans based on the latest loan volume estimates and CBO interest rate projections. These estimates

take into account both special allowance payments and fees, the incremental cost of consolidation loans in excess of Stafford/Plus loans, and the discounted present value of the future cash flows.

The cost of the consolidation loan program varies over time with different interest rate environments. When loan rates at the time of consolidation are high and then interest rates fall (FY1995-2002), the program is estimated to have a net effect of positive $3.7 billion. When loan rates at the time of consolidation are low and interest rates are expected to rise (FY2003-06), the cost is estimated to be $6.1 billion over the four years. When interest rates are relatively stable (FY2007-10), consolidation loans will again return to a positive net effect of $2.3 billion. Over the 16-year period, the FFEL consolidation loan program is estimated to be essentially cost neutral (less than negative $0.2 billion).

When the HEA reauthorization occurs, only changes to the consolidation loan program will be scored for budget purposes. The expected cost of the current loans has already been included in prior budgets, and will not affect the HEA reauthorization budget.

Budget Effects[1] of FFEL Consolidation Loans FY1995-2010



[1] Budget effect is the net present value of the incremental impact of consolidation loan program. Methodology is described in Ernst & Young LLP, "The Net Incremental Cash Flow and Budget Effects of the FFEL Consolidation Loan Program, FY2005-FY2010" (August 2003), updated with loan volumes from U.S. Department of Education, *Student Loan Volume Tables- FY 2005 President's Budget* and interest rate projections from the Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2005 to 2014" (January 2004).

The Benefit Side

The FFEL consolidation loan program was enacted to provide student loan borrowers with a simpler loan repayment plan, plus a one-time opportunity to lock in a longer payment term and a fixed interest rate to reduce the likelihood of default. A lower, fixed monthly payment was thought to result in lower default rates for student borrowers. How much of the lower default effect is due to the extended repayment period, the fixed interest rate, or the type of student refinancing the loans, has not been studied, but that information would be helpful for policymakers to know.

One benefit, particularly during the current low interest rate environment, is the ability of student borrowers to lock in a fixed interest rate. This is similar to what has happened in the residential mortgage market, where there has been an explosion of refinancing to lower families' mortgage interest expense and monthly payments. Recent developments in the mortgage market to allow borrowers to choose fixed rate or variable rate loans with different maturities have been a major benefit to both borrowers and the residential housing market. Private market lenders are willing to lend money at 4-6% interest rates for 15-30 years. If interest rates go up as the CBO projects, many mortgage lenders will experience lower returns on those fixed mortgages, while the borrowers will view them as very beneficial.

Similarly, the potential cost of the FFEL consolidation loan program for loans originated between July 1, 2002 and June 30, 2004 could be large if interest rates rise as the CBO projects. The total net incremental cost of those two years of loans is an estimated $3.4 billion in net present value terms. On the borrower side, the student loan borrowers will benefit significantly from the low 3.5% fixed interest rate. The March 2004 study, "The Effect on Student Borrowing Costs If Consolidation Loans Were Variable Rate Loans Rather Than Fixed Rate Loans," shows the effect on borrower costs if those consolidation loans had not been available at a fixed rate.

Using a $30,000 20-year consolidation loan originated in July 2003 at 3.5%, and the CBO interest rate projections, the monthly payment would increase 34% from $174 under a fixed rate loan to $233 in 2008 if it had been a variable rate loan. The total interest expense would increase from $11,800 to $22,900 over the life of the loan, a 95% increase. The variable rate loan would have the same total interest cost as a comparable 6.32% fixed rate loan, 2.72% above the current fixed consolidation loan rate.

The benefits of the fixed interest rate include potentially lower default rates and the ability to lock in a lower rate. Congress has limited the ability of student borrowers to refinance their student loans more than once. The budget cost, which provides the interest rate subsidy for the borrower's benefit, is one reason for the limitation on student loan refinancing.

Conclusion

The FFEL consolidation loan program is an important part of the Higher Education Act reauthorization. The consolidation loan program's benefits and costs are not easily measured, and continually revised interest rate projections and different methodologies result in a myriad of numbers. I hope these two reports and these updated estimates provide the Committee with useful information for your deliberations, particularly the important considerations that:

- Consolidation student loans are not all alike from a cost perspective. The net cost of future consolidation loans will be much less, even positive, compared to the estimated cost of the current 3.5% loans.

- The reported cost of the consolidation loan program will be overstated unless lender-paid loan fees, the net cost above the cost of the otherwise underlying Stafford/Plus loans, the discounted present value of future cash flows, and government interest rate projections are included in the analysis.

That concludes my testimony. I would be happy to answer any questions about my testimony and the two consolidation loan studies.